California's GO Bond Rating Raised to `AA-' from `A+'; Outlook Revised to Stable from Positive

NEW YORK (Standard & Poor's CreditWire) Aug. 10, 1999– Standard & Poor's raised its rating on California's GO debt to double-'A'-minus from single-'A'-plus. The rating action affects $19.8 billion GO bonds.

Additionally, Standard & Poor's revised the outlook on the state's bonds to stable from positive.

The upgrade reflects California's strong economic performance and a return to structural fiscal balance as demonstrated by:

- Fiscal 1998's positive GAAP general fund balance,
- A continued positive budgetary basis fund balance at the end of fiscal 1999, and
- Conservative budgeting in the adopted fiscal 2000 state budget.

The 2000 budget was adopted on time for the first time in a number of years and includes economic assumptions more conservative than that of most outside forecasters, as well as about $1.7 billion in onetime expenses, and, in addition, eliminates prior years' reliance on unlikely federal aid.

Additionally, the rating reflects the following strengths:

- A strong, diversified, and growing economy that has demonstrated resilience in light of weaknesses in Asia, which is one of California's key export markets; and
- Debt levels are expected to remain moderate despite the authorization of $9.2 billion in additional GO bonds for local schools and higher education.

However, the rating is offset by the following weaknesses:

- Reserve levels that are relatively small, particularly as measured against the size of the state budget, in light of slight operating deficits projected for fiscals 1999 and 2000; and
- Structural impediments, including state spending allocations that are substantially constrained by Proposition 98's funding requirements for schools, and the historical lack of mid-year budget adjustments or a mid-year budget adjustment mechanism when budgets have proved to be unbalanced.

California's diverse economy of 33 million people has demonstrated surprising resilience, particularly in light of the weakness in Asian economies, which accounted for over 31.6% of state exports in 1998--although Asian exports remain only a small portion of total gross state product. Total state employment grew 3.8% in 1998 despite the loss of 46,000 manufacturing jobs, stemming, in part, from Asian-related weakness in electronics and aerospace. The loss in manufacturing employment was more than made up for by 17% job growth in fiscal 1999 in computer services and software, particularly from internet services, growth in telecommunications, motion pictures, consulting, and other areas. Additionally, growth in construction employment increased 14% between June 1999 and the previous June, resulting in total employment growth faster than the nation. While employment growth is projected to slow, both population and employment are expected to continue to grow at above national rates. Per capita income levels have stabilized at about 104% of the national average after a long period of relative decline; and the May 1999 seasonally adjusted unemployment rate of 5.3% represents a substantial improvement over the past few years, although remaining higher than the nation.

The bright economic picture has produced revenues above budget. Fiscal year-end June 30, 1998, erased years of large negative fund balances with a $3.0 billion operating surplus, resulting in a positive accumulated GAAP general fund balance of $547 million and a budgetary basis of accounting balance of $2.8 billion or 5.2% of expenditures and transfers. However, the unreserved budgetary balance of $931 million remained small in proportion to operations at just 1.7% of expenditures. In addition, prior missed budgets cast doubt on the state's ability to consistently meet budgetary targets. California subsequently demonstrated results close to budget in fiscal 1999 with both revenues and expenditures slightly higher than expected, resulting in a slight 1.1% operating deficit on a budgetary basis of accounting. The fiscal 2000 budget also projects a small 1.2% operating deficit, bringing total general fund balances down to a still positive $1.7 billion or 2.6% of expenditures and transfers. However, the budget also provides comfort that the state retains flexibility should future periods of economic stress occur. Economic conditions have strengthened since the budget's economic assumptions were set in May. In addition, the budget contains about $1.7 billion in onetime expenditures that do not need to be repeated, matching what are perceived to be onetime revenues. The new budget does not make any major change in previous state spending priorities, although it does increase spending for education slightly above Proposition 98's minimum guarantee--raising the guarantee level for future years. Nevertheless, California's spending on education ranks well-below the national average, and the increase should not pose significant strain.

California's net tax-supported debt remains moderate at about $681 per capita. Debt service is projected to remain low at under 5% of general fund expenditures despite recent voter authorization of $9.2 billion in GO bonds for school capital needs and legislative plans for additional prison lease financing.

Outlook: Stable

The stable outlook reflects the diversity and strength of California's economy coupled with structural budget impediments, such as required supermajority legislative budget approval and Proposition 98's guaranteed levels of education funding, as well as prospects for slim fund balances as a percent of the budget for the foreseeable future, Standard & Poor's said.– CreditWire

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